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No. _____

IN THE
SUPREME COURT OF THE UNITED STATES

THE HENRY E. & NANCY HORTON BARTELS TRUST FOR THE BENEFIT OF THE UNIVERSITY OF NEW HAVEN, Kenneth G. Bartels, John P. Loehmann, Philip H. Bartels, Marilou McLaughlin & Lawrence J. DeNardis, Trustees,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

In order for an exempt organization's passive, debt-financed income (arising from its securities investing on margin) to be subject to the Unrelated Business Income Tax ("UBIT") under §514(a) of the Internal Revenue Code of 1986, as amended, does the tax policy of the UBIT require that the exempt organization's income-producing activity must cause actual (or, at least must it create the potential for) unfair competition by the exempt organization against non-exempt taxpayers?

PARTIES TO THE PROCEEDINGS

Petitioner

The Henry E. and Nancy Horton Bartels Trust for the Benefit of the University of New Haven, Kenneth G. Bartels, John P. Loehmann, Philip H. Bartels, Marilou McLaughlin and Lawrence J. DeNardis, Trustees. Petitioner is a charitable trust and has no corporate affiliations.

Respondent

The United States of America.

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ARGUMENT 2

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The Petitioner, The Henry E. and Nancy Horton Bartels Trust for the Benefit of the University of New Haven, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit (App. 1a-21a) is reported at 209 F.3d 147 (2d Cir. 2000). The opinion of the District Court for the District of Connecticut (App. 22a-30a), *viz.*, its Ruling on Cross-Motions for Summary Judgment, is unreported. The order of the District Court substantively denying the Petitioner's Motion for Reconsideration (App. 31a-32a) is unreported.

JURISDICTION

The United States Court of Appeals for the Second Circuit issued its Opinion on April 11, 2000. On June 14, 2000, Justice Ginsberg extended the time within which to file a petition for a writ of certiorari, to and including August 8, 2000. This Court's jurisdiction is invoked pursuant to 28 U.S.C. §§1254(1) and 2106.

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant sections of the Internal Revenue Code of 1986, as amended (the "Code"), 26 U.S.C. §§1, *et seq.*, and more particularly, the relevant portions of §511-514, are

reprinted in the Appendix. (App. 33a - 40a). (All section references hereinafter are to the Code). The relevant sections of the Treasury Regulations, Reg. §§1.513-1(a) and (b), are also reprinted in the Appendix. (App. 41a - 43a).

STATEMENT OF THE CASE

This case concerns the tax policy of the unrelated business income tax sections (the "UBIT") of the Code, §§511-514. Congress enacted the UBIT in the Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906, specifically to address the deleterious anti-competitive impact created by the then-existing tax laws that had permitted an exempt organization's income arising from a competitive commercial business to remain tax-free. In 1969, Congress expanded the UBIT in §514(a)(1), Pub. L. No. 91-172, 83 Stat. 487, to rectify a debt-financed, new anti-competitive inequity which had been exploited under the tax laws by certain exempt organizations. The precise question presented in this case is whether the debt-financed, passive income arising from the Petitioner's securities investing on margin should be taxable under the UBIT, or whether such passive income (similar to an exempt organization's tax-free passive income which is generated from non-debt-financed securities investing) should be exempt from taxation.

A. *The Petitioner's Status as an Exempt §509(a)(3) Education Supporting Organization.*

The facts of this case are uncomplicated and undisputed in this taxpayer refund action. The Petitioner qualified with the Internal Revenue Service in 1989 as an exempt organization under §501(c)(3) and, importantly, also

as an education supporting organization under §509(a)(3) for the exclusive benefit of the University of the New Haven ("UNH"). The Petitioner's sole purpose and goal is to provide as much financial support as possible for UNH from its principal asset, a securities portfolio (the "Portfolio") managed in a discretionary trading account by the New York City securities firm of Gilder, Gagnon, Howe & Co., Inc. ("Gilder, Gagnon"). A primary vehicle that Gilder, Gagnon has employed to enhance the Portfolio's growth, and thus to further enable the Petitioner to provide financial support to UNH, has been its debt-financed securities investing on margin.

B. *The Facts admitted below.*

In connection with the income arising from the Petitioner's margin trading, the following facts have been admitted in this case:[1]

> • The Petitioner has no employees, and its Managing Trustee expends just one or two hours per month in connection with the activities of the Petitioner. (J.A. 23).
>
> • The Petitioner has no expertise in securities investing and, thus, all securities investing decisions have been delegated by the

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[1] In the District Court below, pursuant to its Local Rule 9(c)(1), because the Government did not controvert or otherwise contest any of the facts in the Petitioner's 4/25/97 Statement of Material Facts (J.A. 20-31), which were supported by two Affidavits attached thereto (J.A. 32-45), therefore, the facts in the Statement of Material Facts were "deemed admitted".

Petitioner, via a customary discretionary trading agreement, to Gilder, Gagnon. (J.A. 22-23).

- Securities purchased on margin are not acquired for the purpose of being held to generate periodic income (such as dividends and interest). Instead, the purpose of acquiring securities on margin is solely to enhance portfolio, or capital, growth which is accomplished when the margined securities are sold. (J.A. 26).

- During the representative period of 1989-1996, the capital growth in Gilder, Gagnon's margined portfolios was on average 213% more than the increase in its portfolios that did not trade on margin. (J.A. 26).

- No unfair, anti-competitive advantage against non-exempt taxpayers arises as a result of:

(a) The Petitioner's receipt of margin trading income. (J.A. 28).

(b) The use by UNH of the Petitioner's contributions arising from such income. (J.A. 28).

(c) Gilder, Gagnon's receipt of fees arising from its margin trading on behalf of exempt organizations (such as the Petitioner). (J.A. 28-29).

- Securities trading on margin increases liquidity in the securities markets, which in turn creates the following benefits: (i) it increases the ability of buyers and sellers to trade larger positions of stock, thereby making the securities markets more attractive to investors; and (ii) smaller companies are better able to sell their stock. (J.A. 29-30).

C. *The Petitioner's Claims for Refund; the Taxpayer Refund Action; the District Court Ruling.*

In connection with its passive income activities, the Petitioner paid the UBIT (with interest and penalties) on its debt-financed investment income for 1991-1993 and promptly filed §6402 Claims for Refund with the Service for each tax year. Upon the Service's denial of said Claims, the Petitioner timely commenced this action pursuant to §1346(a)(1) in the District Court for the District of Connecticut with its complaint, dated June 5, 1996, for the recovery of the UBIT taxes erroneously collected. The District Court, in its Ruling on Cross-Motions for Summary Judgment, filed March 17, 1998, held that the UBIT did apply to the Petitioner's margin trading income pursuant to §511. (App. 23a). The District Court thereafter substantively denied the Petitioner's Motion for Reconsideration. (App. 32a).

D. *The Court of Appeals Decision.*

When it handed down its reported decision on April 11, 2000, in affirming the District Court's decision, the United States Court of Appeals for the Second Circuit departed from the holdings of this Court and also sister

circuits. Although acknowledging that this Court has long held in a number of decisions such as *Higgins v. Commissioner*, 312 U.S. 212 (1941), that securities investing is not the conduct of a "trade or business", and although the court also acknowledged that the UBIT's primary regulation, Treas. Reg. §1.513-1(a) (App. 42a-43a), requires as the first prong of its three-prong test for the imposition of the UBIT that the exempt organization's income must arise from a "trade or business", nonetheless, the court below concluded that the plain language of §512(b)(4) and §514(a)(1) controls. The court held that these sections "require that Taxpayer's income derived from margin-financed securities be treated as income derived from an unrelated trade or business". (App. 9a).

The Second Circuit then turned to the uncontroverted absence of any evidence of unfair competition at the primary, secondary, or tertiary levels arising from the Petitioner's margin trading income. The court did not give primacy to the UBIT's tax policy of restraining unfair competition and instead held that the UBIT's legislative history does not require that unfair competition "must be shown for the imposition of the UBIT". (App. 16a).

The third part of the Second Circuit's decision dealt with the clause, "which is held to produce income", within §514(b)(1)'s definition of debt-financed property ("[T]he term, 'debt-financed property' means any property which is held to produce income and with respect to which there is acquisition indebtedness"). The court concluded that said clause refers both to periodic income (*e.g.*, rental income) and also to non-recurring income such as capital gains. (App. 17a-18a).

In the final section of its decision, the Second Circuit addressed the two statutory exemptions to §514(a)(1). These exemptions provide that, if the use of the debt-financed income is "substantially related to" (§514(b)(1)(A)(i)), or if the incurrence of the debt-financed income is "inherent in" (§514(c)(4)), the exempt organization's purpose or function, then the UBIT does not apply. The court concluded that these statutory exemptions were inapplicable to the Petitioner's margin trading income. (App. 20a).

REASONS FOR GRANTING THE WRIT

Even though the UBIT comprises only four of the thousands of Code sections, nevertheless, the UBIT has been a matter important enough that this Court has accepted, and has issued lengthy decisions on, three UBIT petitions for certiorari in the last fifteen years. It is in this context of an important federal question that the Petitioner urges this Court to grant its petition for a writ of certiorari in order to give plenary consideration to an issue of substantial importance: *first*, because the Court of Appeals' decision directly conflicts with and is incompatible with the relevant decisions of this Court (Sup. Ct. R. 10(c)); and, *second*, because the decision below has continued the long-standing, square and irreconcilable conflict among the now evenly-divided circuits, which needs to be resolved on an important federal question so as to ensure the uniform interpretation and administration of the Code throughout the nation, regardless of the circuit in which the exempt organization is located (Sup. Ct. R. 10(a)).

ARGUMENT 1

THERE IS A DIRECT CONFLICT BETWEEN THE DECISION BELOW AND THIS COURT'S DECISION IN *PORTLAND GOLF CLUB v. COMMISSIONER*, AND THE OTHER RELEVANT DECISIONS OF THIS COURT.

A. Specifically in the context of exempt organizations, this Court has, pursuant to its Whole Act Rule, read into the plain text of the tax laws an additional, and tax policy, requirement.

Long ago, this Court stated its Whole Act Rule in *Brown v. Duchesne*, 19 How. 183, 194 (1857), as follows:

> The general words used in the clause . . . , taken by themselves, and literally construed, without regard to the object in view, would seem to sanction the claim of the plaintiff. But this mode of expounding a statute has never been adopted by any enlightened tribunal — because it is evident that in many cases it would defeat the object which the Legislature intended to accomplish. And it is well settled that, in interpreting a statute, the court will not look merely to a particular clause in which general words may be used, but it will take in connection with it the whole statute . . . and the objects and policy of the law . . . .

This Rule was later restated in *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892), the continuing vitality of which was reconfirmed in *United Housing*

Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975), as follows: "[A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers".[2]

Given this background, this Court was confronted in *Bob Jones University v. United States*, 461 U.S. 574 (1983), with the facial compliance by the University with the plain text of §501(c)(3) as constituting both a religious and an educational institution. However, the Government argued that an additional requirement had to be read into the statutory language of the tax laws, *viz.*, that an exempt organization also had to serve a charitable purpose. In ruling for the Government, this Court engaged in a two-step analysis. First, it reached back to its decision *Brown v. Duchesne*, 19 How. at 194, and specifically cited the Whole Act Rule (as quoted hereinabove) as its precedent that: "It is a well-established canon of statutory construction that a court should go beyond the literal language of a statute if reliance on that language would defeat the plain purpose of the statute". *Id.* at 586.[3]

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[2] The importance of the Whole Act Rule was re-emphasized just three months ago in *Johnson v. United States*, slip op. 15 n.10, ____U.S. ____, 120 S.Ct. 1795, 1805 n.10 (2000): "[B]ut we have never treated the [statutory] text as such a jealous guide and have [instead] traditionally sought to construe a statute so as to reach results consistent with what Chief Justice Taney called 'its object and policy'" (citing *United States v. Heirs of Boisdore*, 8 How. 113, 122 (1849)).

[3] A similar rationale was applied in *Gregory v. Helvering*, 293 U.S. 465 (1935). Therein, despite the taxpayer's literal compliance with each and every element of the plain language of the tax laws' reorganization provision, but "because the transaction upon its face lies outside the plain intent of the statute", thus, this Court held that the subject provision of the tax laws did not apply. *Id.* at 470.

Second, this Court then proceeded to make an in-depth analysis of the legislative history of §501(c)(3), and its predecessor provisions, in order to glean the tax policy underlying the application of §501(c)(3).

In a foreshadowing of its three UBIT decisions, and predicated on its legislative history analysis, this Court was willing to read the additional requirement into the statutory text because an alternate interpretation would undermine the tax policy of §501(c)(3). Thus, this Court held that not only must an exempt organization fall within one of the eight categories specifically enumerated in the text of §501(c)(3) but, additionally, the organization must also serve a valid charitable purpose. *Id.* at 591-92.[4]

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[4] In his concurring opinion, 461 U.S. at 607 n.1, and as support for this Court's ability to read additional requirements into the text of the tax laws, Justice Powell cited two earlier decisions of this Court in which it had utilized a tax (or, public) policy basis for limiting the application of the plain language of the tax laws, *viz.*, *Commissioner v. Tellier*, 383 U.S. 687, 693-94 (1966); *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30, 35 (1958). *Cf. United States v. Estate of Romani*, 523 U.S. 517, 534 (1998) ("policy concerns" govern the scope of the application of the Tax Lien Act of 1966, 26 U.S.C. §§6321, *et seq.*).

B. *This Court, in its three UBIT decisions, has similarly read an additional, tax policy requirement into the plain text of the tax laws in order to effectuate the clear legislative history of the UBIT.*

In each of its UBIT decisions, this Court has carefully delved into the UBIT's legislative history in order to discern its tax policy and, in turn, then to determine the UBIT's sweep and application. In the first UBIT decision, *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986), after analyzing the 1950 Hearings before the House Committee on Ways and Means and also the House Report, H.R. Rep. No. 2319, 81st Cong., 2d Session (1950), this Court confirmed that: "[I]n the 1950 Act [, when first enacting the UBIT, Congress] struck a balance between its two objectives of encouraging benevolent enterprise and restraining unfair competition by imposing a tax on the 'unrelated business taxable income' of tax-exempt organizations. 26 U.S.C. §511(a)(1)."

This Court two months later in *United States v. American Bar Endowment*, 477 U.S. 105, 114 (1986), went even further in its analysis of the legislative history and succinctly concluded: "The undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed". (Cits. omitted).[5] Then, in order to

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[5] An earlier instance in which this Court read an additional, legislative history requirement into the otherwise plain text of the tax laws is *Commissioner v. Bilder*, 369 U.S. 499, 502 (1962), wherein this Court stated that "the congressional purpose [was] explicitly revealed in the House and Senate Committee Reports" and, thus, this Court "must give

remove any doubt with regard to its reading of this additional, tax policy requirement into the statutory text of the UBIT, this Court in *Portland Golf Club v. Commissioner*, 497 U.S. 154, *161-62 (1990), crisply stated its bright line UBIT Test:*

> Taxes are levied on "unrelated business income" only in order to prevent tax-exempt organizations from gaining an unfair advantage over competing commercial enterprises. See *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986) ("Congress perceived a need to restrain the unfair competition fostered by the tax laws"). (Footnote omitted).

This Court proceeded to observe (and as is directly applicable herein with regard to the Petitioner's passive investment activities) that:

> Since Congress concluded that investors reaping tax-exempt income from passive sources could not be in competition with commercial businesses, it excluded from tax the investment income realized by exempt organizations. [Footnote citation to S. Rep. No. 2375, at 30-31; H.R. Rep. No. 2319, at 38]. *Id.* at 162.

Simply stated, this is precisely the set of circumstances relating to the Petitioner's income-producing activity: (i) it is

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the statute [the] effect in accordance with the purpose so clearly manifested by Congress", *Id.* at 504 n.5.

wholly passive; and (ii) there is no actual, or potential for, competition even on the remote, tertiary level.

In sum, these three decisions have imposed the legislative history, tax policy requirement that, in order to trigger the application of the UBIT, the exempt organization had to have been engaged in actual competition with taxable entities. Moreover, even when actual unfair competition was not shown, but instead the exempt organization's activity presented just the "potential for unfair competition", the UBIT nonetheless is triggered. *American Bar*, 477 U.S. at 114.

Despite the undeniable and long-standing clarity of these precedents with respect to this Court's unfair competition tax policy requirement,[6] the Court of Appeals made only the briefest of references to the three UBIT decisions, and deliberately chose to ignore them. (App. 14a-15a). In its explicit rejection of the UBIT Test, the Court of Appeals incorrectly held that unfair competition does not need to be shown for the imposition of the UBIT. (App. 16a). Thus, even though there was an uncontroverted absence of actual (or even the potential for) unfair competition arising from the Petitioner's investment activities (App. 9a), and therefore the UBIT's tax policy has not been implicated, the court nevertheless departed from this Court's three UBIT

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[6] The primary Code regulation similarly adopts the UBIT Test: "[T]he unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' ... presents sufficient likelihood of unfair competition to be within the policy of the tax". Treas. Reg. §1.513-1(b). (App. 42a-43a).

decisions and erroneously held that the UBIT did apply to the Petitioner's margin trading income. (App. 10a). The court below therefore created a conflict with the three UBIT decisions that is truly direct and readily apparent from the face of its decision.

C. *Conclusion for Argument 1: Because the question presented in this tax case will recur on an increasingly frequent basis, the direct conflict created by the decision below will have continuing future consequences.*

The task of policing, and thereby ensuring the continuing validity of, the three UBIT decisions lies strictly with this Court. The timely and compelling reason that this Court now needs to address and reverse the decision below, which is directly at odds with this Court's long-established precedents on an important federal question, is the securities markets' recently-established primacy to our economy. More specifically, with the explosive growth and conclusive importance of the securities markets in the last several years, and the desire by investors (exempt or otherwise) to maximize their portfolio growth therein, thus, the issue presented herein with respect to an exempt organization's securities investing on margin is very likely to recur on an increasingly frequent basis.

Confirmation of this conclusion is provided, in part, by the fact that the number of exempt organizations has dramatically increased since, for example, the Service's 1,100 page October 1981 *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1954* that was cited by Justice Powell in his concurring opinion in *Bob Jones*, 461 U.S. at 609 n.3. Today, the length

of the current *Cumulative List* (Revised to December 31, 1999) has nearly tripled to 2,869 pages (which are single-spaced and three columns wide). Indeed, the timeliness and importance of this question is heightened by the Service's most-recent statistics on exempt organizations, as set forth in its publication, *Statistics of Income Bulletin*, Fall, 1998, *viz.*: (i) by 1995, there were approximately 1.2 million §501(c) exempt organizations; and (ii) of the 181,000 exempt organizations required to file Form 990 in 1995, their assets totaled $1.9 trillion and (as particularly relevant herein) their total income in 1995 was $899 billion. *CCH Exempt Organizations Reports*, ¶10,015, at p. 12,081. Thus, this important federal question (with its consequences for other litigants) therefore needs to be settled now so that the ever-increasing number of exempt organizations can have the opportunity to engage in securities investing (whether on margin or not), without having to consider any issues of taxation, in order to be able to strictly focus on maximizing their financial efforts to implement their societally-important charitable work.

ARGUMENT 2

THIS COURT HAS A RESPONSIBILITY TO RESOLVE THE SQUARE AND IRRECONCILABLE CONFLICT AMONG THE EVENLY-DIVIDED CIRCUITS OVER WHETHER THE APPLICATION OF THE UBIT REQUIRES THAT AN EXEMPT ORGANIZATION'S INCOME-PRODUCING ACTIVITY MUST CREATE UNFAIR COMPETITION, BECAUSE THE RESULTING UNCERTAINTY DIRECTLY CALLS INTO QUESTION THE UNIFORM INTERPRETATION AND ADMINISTRATION OF THE TAX LAWS THROUGHOUT THE NATION.

A. *The decision below further contributes to the irreconcilable, and now evenly-divided, direct conflict among the Circuits.*

The Second Circuit has now held, and three other Circuits have similarly held,[7] that unfair competition by an exempt organization does not need to be shown as a predicate to the UBIT's application. Critically, however, this line of rulings directly conflicts with decisions from four other Circuits.[8] This has not been some sort of a short-lived, reconcilable circuit conflict that shows signs of abating; to the contrary, it is an irreconcilable conflict reaching back to 1987, on which the courts of appeals are recurringly at odds, that can only be resolved by this Court on an issue involving an important federal question.

An example of the decisions from the four circuits that squarely conflict with the opinion below is *Independent Ins. Agents v. Commissioner*, 998 F.2d 898 (11th Cir. 1993).

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[7] *See, e.g., State Police Ass'n v. Commissioner*, 125 F.3d 1, 8 (1st Cir. 1997), *cert. den.* 522 U.S. 1108 (1998); *NCAA v. Commissioner*, 914 F.2d 1417, 1425 (10th Cir. 1990); *Fraternal Order of Police, Illinois State Troopers, Lodge 41 v. Commissioner*, 833 F.2d 717, 722-23 (7th Cir. 1987) (overruling, without citation, *Hope School v. United States*, 612 F.2d 298, 304 (7th Cir. 1980)).

[8] *See, e.g., Oregon State University Alumni Ass'n v. Commissioner*, 193 F.3d 1098, 1101-02 (9th Cir. 1999); *American Academy of Family Physicians v. United States*, 91 F. 3d 1155, 1159-60 (8th Cir. 1996) (overruling, without citation, *Clarence LaBelle Post No. 217 v. United States*, 580 F.2d 270, 272 (8th Cir. 1978), *cert. dismissed* 439 U.S. 1040 (1978)); *Independent Ins. Agents v. Commissioner*, 998 F.2d 898, 902-03 (11th Cir. 1993); *American Bar Endowment v. United States*, 761 F.2d 1573, 1577 (Fed. Cir. 1985), *rev'd on other grounds* 477 U.S. 105 (1986).

Therein, members of an exempt business league, the Independent Insurance Agents of Huntsville ("IIAH"), had sold insurance policies to local public bodies such as the Huntsville Public Library. The commissions were "split between IIAH and the member, with IIAH receiving 40-60% of the proceeds". *Id.* at 900. In affirming the Tax Court's application of the UBIT to the IIAH's income, the Eleventh Circuit held:

> The brokering of [insurance] business by IIAH creates unfair competition in the marketplace and is of decided disadvantage to non-members. *United States v. American Bar Endowment,* 477 U.S. 105 (1986). . . . [T]he unrelated business income tax was enacted to eliminate one source of unfair competition by tax-exempt organizations with private industry. We agree with the tax court that IIAH is engaged in the conduct of a trade or business that is regularly selling public insurance. . . . Consequently, the income is taxable under §511. *Id.* at 902-03.

Similarly, in *American Academy of Family Physicians v. United States*, 91 F.3d 1155, 1159 (8th Cir. 1996), the Eighth Circuit refused to apply the UBIT where the exempt organization: (i) "was not engaged in the kind of activities that concerned the Supreme Court in *American Bar Endowment*"; and (ii) had not "sought a competitive edge for the group insurance program based on the [organization's] tax-exempt status".

Likewise, as held in *American Bar Endowment v. United States*, 761 F.2d 1573, 1577 (Fed. Cir. 1985), *rev'd on other grounds* 477 U.S. 105 (1986), the test for applying

the UBIT is whether the exempt organization was operated in a competitive and commercial manner. In sum, these four circuits, which have added the tax policy requirement of unfair competition as a precondition to the application of the UBIT, have accurately read the legislative history (which is discussed above in the first argument) and have correctly applied the UBIT.

B. *Conclusion for Argument 2: Uniformity of national law, which is particularly crucial in the context of the tax laws, is the very essence and strength of our federal system.*

The timely and compelling reason for this Court to resolve this square and irreconcilable conflict among the circuits rests on an overriding governmental interest that is directly at stake herein. More specifically, it is the core principle that, with respect to the interpretation and administration of the tax laws, similarly-circumstanced taxpayers must (in the absence of a rational reason for differing treatment) be treated similarly. *See, e.g., United States v. Kaiser*, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring) ("The Commissioner cannot tax one and not tax another without some rational basis for the difference.").

This "root requirement" of even-handed, singular treatment has its genesis in two constitutional provisions. First, the Taxation Uniformity Clause provides: "The Congress shall have power to lay and collect Taxes, Duties, Imposts and Excises, . . . but all Duties, Imposts and Excises shall be uniform throughout the United States". U.S. Const. art. 1, §8, cl. 1. Income taxes are classified as duties, imposts and excises, or, in other words, indirect taxes, *See, e.g., Brushaber v. Union P.R. Co.*, 240 U.S. 1, 15 (1916),

and, therefore, they must be geographically uniform. "[A] tax is uniform when it operates with the same force and effect in every place where the subject of it is found". *United States v. Ptasynski,* 462 U.S. 74, 82 (1983) (quoting *Head Money Cases*, 112 U.S. 580, 594 (1884)). The second underlying constitutional provision is the Equal Protection doctrine under the Fifth Amendment, which requires that similarly situated individuals (and entities) are to be treated similarly. *See, e.g., Johnson v. Robison*, 415 U.S. 361, 374-75 (1974). The net result, as confirmed in the exhaustive opinion in *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985), is that: "[U]niformity of decision among the circuits is vitally important on issues concerning the administration of the tax laws". (Cits. omitted).

In the increasingly recurring context of exempt organizations' margin trading income, and as a result of the ever growing geographic checkerboard of circuits that are squarely divided on the UBIT competition issue, many exempt organizations could even become required to jockey the location of their headquarters or their operations just to find a friendly circuit. Certainly, such an unnecessary and costly disruption of charitable institutions would directly conflict with, and would create troublesome ramifications with respect to, the seminal principle underlying the long-standing Federal policy (as implemented via the Code and its predecessor revenue acts) of indirectly assisting exempt organizations:

> Charitable exemptions are justified on the basis that the exempt entity confers a public benefit — a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already

> supported by tax revenues. *Bob Jones*, 461 U.S. at 591. (Footnote omitted).

Or, as stated in another way, by Bruce R. Hopkins in his Treatise, *The Law of Tax-Exempt Organizations*, 7th Ed. 1998: "[T]he various Internal Revenue Code provisions comprised in the tax exemption system exist as a reflection of the affirmative policy of American government to refrain from inhibiting by taxation the beneficial activities of qualified tax-exempt organizations acting in community and other public interests". (Footnote omitted).

In sum, because federal law necessarily must be maintained in a uniform national condition, Justice White's analysis in *Brown Transport Corp. v. Atcon, Inc.*, 439 U.S. 1014, 1015 and 1017 (1978) (Dissenting to the denial of certiorari), is especially instructive in the context of a petition for certiorari involving the tax laws:

> [A] conflict among jurisdictions over an issue which "imperatively demand[s] a single uniform rule," *Cooley v. Board of Wardens,* 12 How. 299, 319 (1852), commands the Court's immediate attention. . . . Federal law, statutory or constitutional, being interpreted and enforced differently in different sections of the country . . . has been an important criterion for the exercise of the Court's [certiorari] powers since most of the Court's jurisdiction was made discretionary in 1925.

This unassailable policy of uniformity mandates that this square circuit conflict needs now to be resolved because, a tax system without a predictable and nationwide consistency, cannot whatsoever be reconciled with the guiding principles

emanating from the Taxation Uniformity and Equal Protection Clauses.

Directly put, it is simply intolerable that "citizens in some circuits are subject to liabilities or entitlements that citizens in other circuits are not burdened with or entitled to". *Beaulieu v. United States,* 497 U.S. 1038, 1039 (1990) (White, J., dissenting to the denial of certiorari). Thus, this case is as compelling as *Commissioner v. Bilder*, 369 U.S. 500, 501 (1962), in which, because of "the need for a uniform rule on the [tax laws] point, we granted certiorari to resolve the conflict". (Cit. omitted).

CONCLUSION

For the foregoing reasons, a writ of certiorari should be granted in order that plenary consideration can be given to this important federal question.

Dated: August 4, 2000

Respectfully submitted,

/s/_____

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

[Filed April 11, 2000]

No. 98-6141

HENRY E. & NANCY HORTON BARTELS TRUST FOR THE BENEFIT OF THE UNIVERSITY OF NEW HAVEN, Kenneth G. Bartels, John P. Loehmann, Philip H. Bartels, Marilou McLaughlin & Lawrence J. Denardis, Trustees,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court
for the District of Connecticut

Before: PARKER and POOLER, *Circuit Judges,* and WEXLER,* *District Judge.*

OPINION

WEXLER, *District Judge:*

Plaintiff-appellant The Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven ("Taxpayer"), appeals from a judgment of the United States District Court for the District of Connecticut (Eginton, J.), upon an order granting Taxpayer's motion for reconsideration and, on reconsideration, affirming an order granting the government's motion for summary judgment and denying Taxpayer's cross-motion for summary judgment in Taxpayer's refund action. Because we agree with the district court that Taxpayer's securities purchased on margin constitute debt-financed property and that income derived therefrom is subject to the unrelated business income tax ("UBIT") under §§ 511-14 of the Internal Revenue Code ("Code"), 26 U.S.C. §§ 511-14, we affirm.

I. *BACKGROUND*

The relevant facts, which are undisputed, may be summarized as follows: Taxpayer was created by a Declaration of Trust, dated November 30, 1988. The Internal Revenue Service ("IRS") granted Taxpayer tax-exempt status

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* The Honorable Leonard D. Wexler, Senior District Judge for the Eastern District of New York, sitting by designation.

under §501(c)(3) of the Code on April 24, 1989. Taxpayer was formed to provide support for the University of New Haven ("UNH") and qualified as a "supporting organization" under § 509(a)(3) of the Code. The Declaration of Trust gave Taxpayer's trustees broad discretion in investing its funds.

During the 1991, 1992, and 1993 tax years, Taxpayer invested in securities purchased "on margin," i.e., using funds borrowed from Taxpayer's stockbroker, Gilder, Gagnon, Howe & Co. ("Gilder, Gagnon"). In January 1995, Taxpayer filed Form 990-T, Exempt Organization Business Income Tax Return, for tax years 1991, 1992, and 1993, showing unrelated business income tax due on income derived from its margin-financed securities of $417, $2,948, and $6,123, respectively. Taxpayer paid the tax in full, with interest and penalties, but on May 22, 1995, Taxpayer filed a claim for refund of those payments. On April 25, 1996, the IRS denied taxpayer's refund claim. Taxpayer then brought this refund action.

In the district court, the government filed a motion for summary judgment, and Taxpayer filed a cross-motion for summary judgment. On March 17, 1998, the district court entered an order granting the government's motion and denying Taxpayer's cross-motion. The district court ruled that Taxpayer's income derived from securities purchased on margin is unrelated business taxable income under § 511 of the Code.

Taxpayer moved for reconsideration. The district court granted the motion for reconsideration and, on reconsideration, affirmed its earlier order. Judgment was entered, and Taxpayer filed this appeal.

We now affirm the district court's judgment.

II. *DISCUSSION*

A. *Standard of Review*

We review the district court's grant of the government's motion for summary judgment and denial of Taxpayer's cross-motion for summary judgment *de novo*. *Eisenberg v. Commissioner,* 155 F.3d 50, 53 (2d Cir. 1998).

B. *Unrelated Business Income Tax*

An organization exempt from tax under § 501 of the Code may be subject to the UBIT on income it derives from a trade or business unrelated to its exempt purpose. *See* 26 U.S.C.§ 501(b). Section 511(b) imposes the UBIT on tax-exempt trusts for "unrelated business taxable income," as defined in §512. *Id.* §511(b). Under § 512(a), "unrelated business taxable income" is defined, in general, as the "gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions . . . directly connected with the carrying on of such trade or business." *Id.* §512(a)(l). Section 513, in turn, defines "unrelated trade or business" to include any trade or business "the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501" — subject to certain exceptions not applicable here. *Id.* §513(a).

As a general rule, §512 excludes from tax passive investment income, such as interest, dividends, and royalties, received by exempt organizations. Nevertheless, such investment income is taxable if derived from "debt-financed property," as defined in § 514. Thus, while § 512(b) generally excludes certain items of income from "unrelated business taxable income,"[1] it nullifies these exclusions for income derived from "debt-financed property," providing: "Notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1). . . . *Id.* §512(b)(4). Section 514(a)(1) requires that income earned from "debt-financed property" be treated as income derived from an unrelated trade or business (in the proportion that the basis of the property bears to the amount financed) for purposes of determining unrelated business taxable income. *Id.* § 514(a)(1).[2] The taxability of

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[1] For example, subsection (b)(1) excludes, *inter alia,* dividends and interest; subsection (b)(2) excludes royalties; subsection (b)(3) excludes certain rents; and subsection (b)(5) excludes certain gains from the sale, exchange or other disposition of property. 26 U.S.C. §512(b)(1), (2), (3), (5).

[2] Section 514(a)(1) provides:

> (a) Unrelated debt-financed income and deductions. - In computing under section 512 the unrelated taxable income for any taxable year -
>
> (1) Percentage of income taken into account - There shall be included with respect to each debt-financed property as an item of gross

income from debt-financed property has no effect on the tax-exempt organization's tax-exempt status, but the income the organization derives from debt-financed property is subject to the UBIT as income from an unrelated trade or business. *See id.* § 501(b).

"Debt-financed property" is defined as "any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year." *Id.* §514(b)(1). Expressly excluded from debt-financed property is "any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501." *Id.* §514(b)(1)(A)(i).

> income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness (as defined in subsection (c)(7) for the taxable year with respect to the property is of (B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year.

26 U.S.C. § 514(a)(1).

Section 514(c)(1), in turn, defines "acquisition indebtedness" generally as "the indebtedness incurred by the organization in acquiring or improving [debt-financed property]." *Id.* §514(c)(1)(A). Expressly excluded from acquisition indebtedness is "indebtedness the incurrence of which is inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption, such as the indebtedness incurred by a credit union described in section 501(c)(14) in accepting deposits from its members." *Id.* §514(c)(4).

C. *Imposition of UBIT on Taxpayer's Income Derived from Securities Purchased on Margin*

Taxpayer argues that the income it derived from securities purchased on margin is not subject to the UBIT because: (1) Taxpayer's securities investment activities, including margin trading, do not constitute conduct of a "trade or business" under the Code; (2) neither Taxpayer nor any third-party (*i.e.*, UNH or Gilder, Gagnon) derived a direct or indirect "unfair competitive advantage" over taxable entities from Taxpayer's margin trading and the income derived therefrom; (3) Taxpayer's securities purchased on margin are not "debt-financed property" under §514(b)(1); and (4) the exceptions to "debt-financed property" and "acquisition indebtedness" under §514(b)(1)(A)(i) and §514(c)(4), respectively, apply to exclude Taxpayer's income derived from securities purchased on margin from the UBIT. We disagree with Taxpayer's arguments, each of which we address below, and hold, as did the district court, that Taxpayer's income derived from margin-financed securities is subject to the UBIT under §§511-14 of the Code.

1. *Unrelated Trade or Business*

Taxpayer initially argues that its securities investment activities, particularly its margin trading, do not constitute a "trade or business" under the Code, and, therefore, the income it derived from margin-financed securities is not subject to the UBIT. In this respect, Taxpayer argues that in determining whether an exempt organization's income is subject to the UBIT as "unrelated business taxable income" the following three requirements must be met: "(1) [i]t is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions." Treas.Reg. § 1.513-1(a); *see United States v. American College of Physicians,* 475 U.S. 834, 838-39 (1986). Taxpayer maintains that the first prong of this test is not met because Supreme Court decisions, such as *Higgins v. Commissioner,* 312 U.S. 212 (1941), and *Whipple v. Commissioner,* 373 U.S.193 (1963), hold that securities investing is not the conduct of a "trade or business." As further set out below, we find no merit to Taxpayer's argument.

Under the plain language of the UBIT, the purchase of securities on margin is a purchase using borrowed funds; therefore, under §514(c), the securities are subject to an "acquisition indebtedness." *See Elliot Knitwear Profit Sharing Plan v. Commissioner*, 614 F.2d 347, 348-51 (3d Cir. 1980). Thus, the margin-financed securities constitute "debt-financed property" under §514(b)(1). As "debt-financed property," §512(b)(4) and §514(a)(1) require that the income derived from these securities be treated "as an item of

gross income derived from an unrelated trade or business" (in the proportion that the basis of the property bears to the amount financed), and, therefore, this income is included in the §512 computation of unrelated business taxable income. *See, e.g., id.* (holding securities purchased on margin are subject to UBIT, as margin-financed securities are debt-financed property, and §514(a) requires treating income derived therefrom as income from unrelated trade or business). Thus, Taxpayer's reliance on Supreme Court decisions construing "trade or business" in other contexts and under the general test for determining unrelated business taxable income is misplaced because § 512(b)(4) and § 514(a)(1) require that Taxpayer's income derived from margin-financed securities be treated as income derived from an unrelated trade or business.

2. *Unfair Competition*

Despite the plain language of the UBIT, and its straightforward applicability to the income Taxpayer derived from margin-financed securities, Taxpayer argues that the UBIT does not apply here because neither Taxpayer nor any third-party derived, directly or indirectly, an "unfair competitive advantage" over taxable entities. Taxpayer asserts that because there has been no showing of "unfair competition," the income it derived from margin-financed securities is not subject to the UBIT. We find no merit to this argument.

First, and foremost, there is nothing in the plain language of the UBIT requiring a showing of unfair competition. Nevertheless, Taxpayer maintains that the legislative history of the UBIT compels such a requirement

because Congress's "sole" purpose in enacting the UBIT was to prevent the business activities of tax-exempt organizations from gaining an unfair competitive advantage over taxable entities. Taxpayer relies on *Greene v. United States*, 79 F.3d 1348 (2d Cir. 1996), in which this Court stated: "Although a statute's plain language is generally dispositive, it sometimes will yield when evidence of legislative history is so strong to the contrary that giving a literal reading to the statutory language will result in defeating Congress' purpose in enacting it." *Id.* at 1356. Although we believe that the plain language of the UBIT is dispositive here and should end our inquiry, resort to the legislative history does not, in any event, assist Taxpayer.

Since the first income tax, various organizations, including those established for charitable and educational purposes, have received exemption from income taxes. *Rensselaer Polytechnic Inst. v. Commissioner*, 732 F.2d 1058, 1060 (2d Cir. 1984) (citing relevant revenue acts). Prior to 1950, the tax-exemption provisions were interpreted to allow tax-exempt organizations to acquire commercial business enterprises and avoid paying taxes on the income generated. *See C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951). As this Court later observed in *Rensselaer Polytechnic*, Congress "[r]ecogniz[ed] . . . the unfair competitive advantage that freedom from income taxation could accord tax-exempt institutions that entered the world of commerce," and so, in 1950, "extended the income tax to the 'unrelated business income' of certain tax-exempt institutions." *Rensselaer Polytechnic*, 732 F.2d at 1061 (citing Pub. L. No. 81-814, §301, 64 Stat. 906, 947 (1950)). As this Court further observed: "[Congress's] objective in changing the law was to eliminate the competitive advantage

educational and charitable corporations enjoyed over private enterprise, without jeopardizing the basic purpose of the tax-exemption." *Id.* (citing H.R. Rep. No. 81-2319 at 36-38 (1950); S. Rep. No. 81-2375 at 28-30 (1950)).

One of the earliest cases addressing the legislative history of the UBIT was *Clarence LaBelle Post No. 217 v. United States*, 580 F.2d 270 (8th Cir. 1978). In *Clarence LaBelle*, a tax-exempt organization sued for a refund of tax paid on its income from bingo games, after the IRS treated the bingo games as an unrelated trade or business under §513 and taxed the income under §511. The organization argued, *inter alia*, that income from an unrelated trade or business may be taxed only if the trade or business competes with a taxpaying entity, and that it was not subject to the tax because only tax-exempt nonprofit organizations may operate bingo games under the applicable state law. *Id.* at 271. The Eighth Circuit disagreed and held that "the tax on unrelated business income is not limited to income earned by a trade or business that operates in competition with taxpaying entities." *Id.* at 272. In reviewing the legislative history of the UBIT, the Eighth Circuit concluded that Congress enacted §§ 511-513 in order to "close a tax loophole" and raise additional revenue, as well as to eliminate a form of unfair competition. *Id.*

As for §514, this section initially was "designed to prevent, *inter alia*, an exempt organization from trading in real estate on its exemption." *Elliot Knitwear*, 614 F.2d at 350-51. In 1969, Congress amended §514 as part of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, to broaden its reach beyond "debt-financed leases" in order to encompass income from property subject to acquisition indebtedness, *i.e.*, "debt-financed property." *Elliot Knitwear*,

614 F.2d at 351. As the legislative history shows, Congress intended to remedy "weaknesses" in the then-existing UBIT to discourage the exploitation of an exempt organization's tax-exempt status for the benefit of a non-exempt organization in situations such as those addressed in *Commissioner v. Brown,* 380 U.S. 563 (1965), and *University Hill Foundation v. Commissioner*, 51 T.C. 548 (1969), *rev'd,* 446 F.2d 701 (9th Cir. 1971). *See* H.R. Rep. No. 91-413 at 44-46 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1690-91. The House Ways and Means Committee explained the provision as follows:

> [U]nfair business competition [through use of tax-exempt organizations] should be discouraged. . . . [The] way to do so is by eliminating the incentive for owners desiring to sell a business to exploit the tax exemption of nonprofit organizations. This objective can be achieved by imposing the unrelated business income tax on the income received by the exempt organization in proportion to the debt existing on the income-producing property.
>
> Under the bill, the unrelated debt-financed income is included in "unrelated business income." It would be subject to tax, however, only if the income arises from property acquired or improved with borrowed funds and the production of the income is unrelated to the educational, charitable, religious, or other purpose constituting the basis of the organization's tax exemption.

Id. at 46, *reprinted in* 1969 U.S.S.C.A.N. at 1691.

While some courts of appeals, including the Eighth Circuit in *Clarence LaBelle*, have concluded that eliminating unfair competition was one purpose among many that motivated Congress to enact the UBIT, other courts of appeals have concluded that eliminating unfair competition was Congress's "primary" purpose. *See Louisiana Credit Union League v. United States,* 693 F.2d 525, 540-41 (5th Cir. 1982) (recognizing two lines of authority: one where courts find prevention of unfair competition to be "primary purpose" and other where courts "prescribed a broader interpretation of the statute, focusing on the multiple objectives of Congress in enacting the unrelated business income tax," and concluding that a "study of the statute, the regulations, the legislative history, and the cases inclines us toward the latter view"); *see, e.g., Julius M. Israel Lodge of B 'nai B 'rith No. 2113 v. Commissioner*, 98 F.3d 190, 194 (5th Cir. 1996) (multiple purposes); *NCAA v. Commissioner*, 914 F.2d 1417, 1425 & n.9 (10th Cir. 1990) (concluding that "[a]lthough prevention of unfair competition was the main purpose behind the [UBIT], revenue raising concerns also played a role in Congress' actions"); *Service Bolt & Nut Co. v. Commissioner,* 724 F.2d 519, 524 (6th Cir. 1983) (primary purpose); *Elliot Knitwear,* 614 F.2d at 350 (primary purpose); *Hope Sch. v. United States*, 612 F.2d 298, 304 (7th Cir. 1980) (primary purpose).

The Supreme Court also has observed that the "undisputed purpose" of the UBIT was to prevent unfair competition. *Portland Golf Club v. Commissioner*, 497 U.S. 154, 161-62 (1990) (citing S. Rep. No. 81-2375 at 28 (1950); H.R. Rep. No. 81-2319 at 36 (1950)); *United States v.*

American Bar Endowment, 477 U.S. 105, 114 (1986); *American College of Physicians*, 475 U.S. at 837-38.

Although Taxpayer argues that *Portland Golf*, *American Bar Endowment*, and *American College of Physicians* "overruled" *Clarence LaBelle's* determination that the elimination of unfair competition was not the "sole" purpose of the UBIT, we find these cases unavailing to Taxpayer, as the Supreme Court did not hold in these cases that unfair competition must be shown for imposition of the UBIT, particularly as applied to "debt-financed property." Similarly, although Taxpayer argues that this Court "held" in *Rensselaer Polytechnic*, 732 F.2d at 1061, and *People's Educational Camp Society. Inc. v. Commissioner*, 331 F.2d 923, 935 (2d Cir. 1964), that "the" purpose of the UBIT was the elimination of unfair competition, these cases also do not assist Taxpayer, as both involved undisputed evidence of unfair competition and did not address whether unfair competition must be shown for imposition of the UBIT. Moreover, Taxpayer cites no court of appeals case holding that unfair competition must be shown for imposition of the UBIT, and our review of the applicable case law reveals that no court of appeals has required such a showing. *See, e.g., State Police Ass'n v. Commissioner*, 125 F.3d 1, 8 (1st Cir. 1997) (holding that imposition of UBIT does not necessarily require showing of actual competition); *NCAA*, 914 F.2d at 1425 (same); *Fraternal Order of Police, Illinois State Troopers, Lodge No. 41 v. Commissioner*, 833 F.2d 717, 722-23 (7th Cir. 1987) (same); *Clarence LaBelle*, 580 F.2d at 272 (holding that actual competition is only one factor to be considered in imposing UBIT).

Taxpayer also argues that the "mischief rule" of statutory construction, as exemplified in *Elliot Coal Mining Co. v. Director, Office of Workers' Compensation Programs,* 17 F.3d 616, 631 (3d Cir. 1994), requires that we bear in mind the mischief that Congress had in view when it enacted the UBIT and interpret the UBIT to tax only that category of conduct within the mischief Congress was attacking, namely, elimination of unfair competition. We reject Taxpayer's argument. Even though Congress enacted the UBIT primarily to eliminate unfair competition, it chose language going beyond the evil which it sought to correct in closing a loophole when it imposed the UBIT on "debt-financed property." As the tax court observed in *Kern County Electrical Pension Fund v. Commissioner,* 96 T.C. 845 (1991), *aff'd by unpublished opinion,* 988 F.2d 120 (9th Cir. 1993):

> We quite agree that Congress was concerned with putting an end to the abuses reflected in *Clay Brown* and *University Hill*. But, although it focused on those particular abuses, the provisions which it enacted were couched in broader terms, and were not limited precisely to those situations. This is but another instance of Congress' going beyond the evil which it seeks to correct in closing a loophole. In the words of Judge Friendly in *Commissioner v. Pepsi-Cola Niagara Bottling*, 399 F.2d 390, 392 (2d Cir. 1968), "a legislature seeking to catch a particular abuse may find it necessary to cast a wider net."

Kern County Elec., 96 T.C. at 853; *see also Elliot Knitwear*, 614 F.2d at 350 (holding that although purchase of securities on margin does not seem to present source of unfair competition, both plain meaning of statute and congressional intent support imposition of UBIT on this type of income). In short, we find no basis for ignoring the plain language of the statute and its applicability to Taxpayer's income derived from debt-financed property even absent a showing of unfair competition. Despite Taxpayer's argument, we cannot say that the legislative history of the UBIT is so "strong to the contrary" that such an application of the statute would defeat Congress's purpose in enacting it.

Accordingly, we reject Taxpayer's argument that unfair competition must be shown for the imposition of the UBIT on income it derived from margin-financed securities.

3. *"Held to Produce Income"*

Next, Taxpayer argues that its margin-financed securities are not "debt-financed property" because § 514(b)(1) defines "debt-financed property" as property that is "held to produce income," and this phrase should be interpreted to include only "periodic" income. We find no merit to this argument for at least two reasons. First, Taxpayer cites no authority for this construction of §514(b)(l), and there is nothing in the statutory language or legislative history of the UBIT supporting this restrictive interpretation. Second, the applicable regulation specifically construes "income" under §514(b)(1) as including both capital gains and recurring or "periodic" income (*e.g.*, dividends). In this respect, Treasury Regulation §1.514(b)-1(a) defines "debt-financed property" as

> any property which is held to produce income (e.g., rental real estate, tangible personal property, and corporate stock), and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property) at any time during the taxable year. *The term "income" is not limited to recurring income but applies as well to gains from the disposition of the property.*

Treas. Reg. §1.514(b)-l(a) (emphasis added). Although Taxpayer urges us to reject the Commissioner's interpretation of the UBIT, we must sustain the regulation unless it is "unreasonable and plainly inconsistent" with the statute. *Fulman v. United States,* 434 U.S. 528, 533 (1978); *Bingler v. Johnson,* 394 U.S. 741, 749-51 (1969).

Section 61(a) of the Code broadly defines income to include "all income from whatever source derived," and lists, as examples, both periodic income (e.g., dividends and interest) and nonperiodic income (e.g., compensation for services; gross income derived from business; and gains derived from dealings in property). 26 U.S.C. § 61(a)(l), (2), (3), (4), (7). There is nothing in the statutory language to suggest that this general definition of "income" is inapplicable to §514(b)(1) or to justify limiting §5l4(b)(1) to "periodic" income. Moreover, the legislative history of the UBIT does not indicate that Congress intended to tax only "periodic"

income under those provisions.[3] Accordingly, we reject Taxpayer's argument that §514(b)(l)'s reference to "debt-financed property" includes only "periodic" income.

4. *Exceptions to Acquisition Indebtedness and Debt-Financed Property*

Finally, Taxpayer argues that even if the income it derived from margin-financed securities would otherwise constitute unrelated business income under §§511 and 512, the exceptions to "debt-financed property" and "acquisition indebtedness" under §514(b)(l)(A)(i) and §514(c)(4), respectively, apply to exclude this income. In this respect, Taxpayer argues that its income is not taxable because (1) the securities it purchased on margin are "substantially related" to its exempt purpose under the §514(b)(l)(A)(i) exception to "debt-financed property"; and (2) its purchase of securities on margin is "inherent" to its exempt purpose under the §514(c)(4) exception to "acquisition indebtedness." We find no merit to Taxpayer's argument, as both exceptions are inapplicable here.

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[3] Indeed, the legislative history suggests otherwise. For instance, the Senate Report to the 1969 amendment to §514 reflects:

> Both the House bill and the committee amendments provide that all exempt organizations' income from "debt-financed" property, which is unrelated to their exempt function, is to be subject to tax in the proportion in which the property is financed by the debt. ... Capital gains on the sale of debt-financed property also are taxed in the same proportions.

S. Rep. No. 91-552 at 63-64 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2092.

The leading case addressing these exceptions is *Elliot Knitwear,* which involved a tax-exempt employee profit-sharing plan which derived income from margin-financed securities. *See Elliot Knitwear,* 614 F.2d at 348. In holding the income subject to the UBIT, the Third Circuit rejected the plan's argument that its margin account fell within the §514(c)(4) exception to acquisition indebtedness because the margin account was "inherent" in the plan's exempt purpose, and the plan's further argument that the margin account fell within the §514(b)(1)(A)(i) exception to debt-financed property because the margin account was "substantially related" to the plan's exempt purpose, namely, accumulation of income for employees for their retirement. *See id.* at 349-51. The court held that "inherent," as used in §514(c)(4), is synonymous with "essential," and concluded that, while investing on margin may have been desirable for the plan, it was not essential to its tax-exempt purpose of providing employee participation in the employer's profits. *Id.* at 349-50. The court reasoned that "while investment of the fund probably is inherent to its tax-exempt purpose, debt-financed investment is not." *Id.* at 350. Thus, the court held that the "purchase of securities on margin is not inherent to the purpose of a tax-exempt profit-sharing plan within the meaning of section 514(c)(4)" and, therefore, not within the exception to "acquisition indebtedness." *Id.*

As for the plan's argument that the §514(b)(1)(A)(i) exception to debt-financed property applied, the court first observed that "[i]t is the property itself, and not the income generated by the property, that must be substantially related to the exempt purpose of the organization." *Id.* In rejecting the plan's argument, the court reasoned:

> It is expected that the buying and selling of income-producing property will be a method utilized to increase, and accumulate income and gains, but such investment activity is a means to accomplish the purpose of deferred compensation it is not the purpose itself of the Plan. Even assuming, arguendo, that investment of contributions for accumulation of income is a function of the Plan, indebtedness or acquisition of securities on margin is not necessary for such accumulation or that purpose.

Id. Moreover, the court recognized that the "statute does not exclude property that is substantially related by virtue of 'the need of the organization for income or funds.'" *Id.* (quoting 26 U.S.C. § 514(b)(1)(A)(i)).

We find the *Elliot Knitwear* court's reasoning persuasive, and accordingly conclude that Taxpayer's purchase of securities on margin does not fall within the "inherent" purpose exception or the "substantially related" exception to §514.

Taxpayer's exempt purpose is to provide funds to support UNH's educational programs. Taxpayer's purchase of securities on margin is not "inherent" or essential to that purpose. Indeed, many alternative investments, whether involving borrowed funds or not, are available to Taxpayer for generating income. Taxpayer's indebtedness incurred from its margin borrowing is readily distinguishable from the statute's example of indebtedness that is "inherent" to an organization's exempt purpose, namely, "the indebtedness

incurred by a credit union . . . in accepting deposits from its members." 26 U.S.C. § 514(c)(4). Taxpayer need not purchase securities on margin to generate income from trading in securities.

For similar reasons, Taxpayer's securities purchased on margin are not "substantially related" to Taxpayer's exempt purpose of supporting UHN's educational programs. As the Third Circuit noted in *Elliot Knitwear,* the use of the property itself, not the income generated by the property, must be substantially related to the exempt purpose. *Elliot Knitwear,* 614 F.2d at 350. Taxpayer's argument ignores that the exception does not apply to property "substantially related" merely by virtue of "the need of the organization for income or funds." While margin-financed securities may be useful to accomplish that exempt purpose by their ability to generate income, their purchase and use is not substantially related to Taxpayer's tax-exempt purpose within the meaning of §514(b)(1)(A)(i). *See id.*

Thus, Taxpayer's borrowing to purchase securities is not "inherent" to its exempt purpose; and its margin-financed securities are not "substantially related" to its exempt purpose. Accordingly, the district court correctly held that the exceptions in §514(b)(1)(A)(i) and §514(c)(4) do not apply.

III. *CONCLUSION*

We have reviewed Taxpayer's remaining arguments raised on appeal and find them to be without merit. For the above reasons, we affirm the judgment of the district court.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF CONNECTICUT

[Filed March 17, 1998]

No. 3-96-1018 (WWE)

THE HENRY E. BARTELS AND NANCY HORTON BARTELS TRUST FOR THE BENEFIT OF THE UNIVERSITY OF NEW HAVEN, BY KENNETH G. BARTELS, JOHN P. LOEHMANN, PHILIP H. BARTELS, MARILOU McLAUGHLIN AND LAWRENCE J. DENARDIS, TRUSTEES, *Plaintiffs,*	)
v.	)
UNITED STATES OF AMERICA, *Defendant.*	)

RULING ON CROSS-MOTIONS FOR SUMMARY JUDGMENT

This case presents the issue of whether income that a charitable trust derives from selling securities purchased on margin is taxable as unrelated business income under Section 511 of the Internal Revenue Code ("Code"). More particularly, plaintiff, The Henry E. Bartels and Nancy Horton Bartels Trust for the Benefit of the University of New Haven, by Kenneth G. Bartels, John P. Loehmann, Philip H. Bartels, Marilou McLaughlin and Lawrence J. Denardis, Trustees ("Trust"), seeks a refund from defendant, United States of America, of unrelated business income tax ("UBIT") paid for tax years 1991, 1992 and 1993 on the Trust's income arising from its margin trading during those years.

Currently pending are plaintiff and defendant's cross-motions for summary judgment. Based on the following discussion, the court will deny plaintiff's motion for summary judgment and grant defendant's motion for summary judgment.

Background

The relevant facts are undisputed. The Trust was created by a Declaration of Trust dated November 30, 1988 and was granted tax-exempt status under 26 U.S.C. §501(c)(3) on April 24, 1989. Pursuant to the Declaration of Trust, the trustees were given the power to invest the amounts in the Trust. During the tax years 1991, 1992 and 1993, the trustees elected to invest certain amounts in stocks purchased "on margin." A margin account "is a brokerage account allowing customers to buy securities with money borrowed

from the broker." Barron's Dictionary of Finance and Investment Terms (4th ed. 1995).

The Trust subsequently filed Forms 990T, Exempt Organization Business Income Tax Returns, for the years 1991, 1992 and 1993 which showed UBIT of $417, $2,948 and $6,123, respectively. The Trust paid these amounts in full. On May 22, 1995, the Trust timely filed claims for refunds of all UBIT paid for those three years, together with interest and penalties. The IRS denied these claims on April 25, 1996. Plaintiff thereafter initiated this lawsuit.

Discussion

Section 511(b) of Code imposes a tax on the unrelated business income of tax-exempt trusts. Unrelated business taxable income is defined as "the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business . . . " 26 U.S.C. §512(a)(1). Income earned by a tax-exempt organization on debt-financed property is treated as income derived from an unrelated trade or business. 26 U.S.C. § 514(a).

"Debt-financed property" is defined in § 514(b)(1) as:

> any property which is held to produce income and with respect to which there is an acquisition indebtedness . . . at any time during the taxable year . . . except that such term does not include - -

> (A)(i) any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . .

Section 514(c)(1) sets forth the definition of "acquisition indebtedness." Relevant to this discussion is § 514(c)(4) which states that the term "'acquisition indebtedness' does not include indebtedness the incurrence of which is inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption, such as the indebtedness incurred by a credit union described in section 501(c)(14) in accepting deposits from its members."

Plaintiff essentially presents four arguments in support of its claim that the income derived from its margin trading activities during the years at issue is not subject to the UBIT. First, plaintiff claims that the sole purpose of the enactment of the UBIT was to prevent tax-exempt organizations from gaining an unfair competitive advantage over taxable entities. Plaintiff argues that since its margin trading did not give the Trust an unfair competitive advantage over non-exempt organizations, the UBIT is inapplicable. Second, plaintiff asserts that margin securities are not debt-financed property within the meaning of §514(b)(1) of the Code because they are not "held to produce income." Third, plaintiff claims that the § 514(c)(4) exception to the definition of "acquisition indebtedness" applies. Fourth, plaintiff argues that the securities in its margin account fall within the exception to the

definition of "debt-financed property" under §514(b)(1)(A)(i). The court will address each argument seriatim.

Plaintiff's claim that the UBIT is inapplicable because its trading activities did not give it an unfair competitive advantage is premised on its claim that the elimination of this abuse was the sole purpose in enacting the UBIT. The legislative history, as set forth succinctly in Clarence LaBelle, Post No. 217, Veterans of Foreign Wars v. United States, 580 F.2d 270 (8th Cir. 1978) does not, however, support plaintiff's claim. In LaBelle, the Eighth Circuit wrote:

> Congress enacted these provisions not only to eliminate a form of unfair competition, but also to raise revenue. When President Truman presented his 1950 tax proposal to Congress, he stressed the importance of economic growth. Eliminating the loophole that 'developed through the abuse of the tax exemption accorded educational and charitable organizations' would, he stated, yield additional revenue as well as reduce inequities in the tax system. The House Ways and Means Committee viewed the bill as one designed to reduce the war excise taxes imposed during World War II and replace the resulting lost revenue by closing loopholes and imposing additional taxes. By the time the bill had reached the Senate the Korean War had begun, and the need for additional revenue was even greater. The Senate converted the bill passed by the House 'into a bill to raise revenues.' Thus, although Congress enacted

> sections 511-513 to eliminate a form of unfair competition, that goal existed only as part of a larger goal of raising revenue.

Accordingly, plaintiff's argument that the purpose of the UBIT was solely to eliminate unfair competition is incorrect. Although that was a key reason for the enactment of the UBIT, it was not the only one.

Moreover, as noted by the court in Kern County Elec. Pension Fund v. C.I.R., 96 T.C. 845, 853 (1991), the provisions enacted are framed in broad terms and are not limited to the abuse of unfair competition. Given the purposes of the enactment of the UBIT and scope of the language used in §§ 511-514, plaintiff's claim that the UBIT is inapplicable because the Trust was not engaged in the abuses that the UBIT was designed to prevent, is without support.

Plaintiff claims next that its margin securities are not debt-financed property within the meaning of § 514 (b)(1), which defines debt-financed property as property that is "held to produce income." Plaintiff argues this phrase actually means "held to produce periodic income." Because margin securities are acquired to enhance a portfolio and not to produce periodic income, plaintiff argues that they do not constitute debt-financed property under § 514(b)(1).

The court disagrees with plaintiff's interpretation because there is no basis in the statute to limit the term "income" to "periodic income." A statute is to be read according to its literal terms. Metropolitan Transp. Authority v. F.E.R.C., 796 F.2d 584, 591 (2d Cir. 1986). Adopting

plaintiff's position would require the court to read a meaning into the statute that is not supported by its language. This the court cannot do. Accordingly, plaintiff's argument is without merit.

Plaintiff's third argument relates to whether its margin trading activities fall within the exclusion to the definition of "acquisition indebtedness" set forth in 514(c)(4) because its margin trading was "inherent" to the Trust's exempt purpose. In its fourth argument, plaintiff claims that the exclusion to the definition of "debt-financed property" under § 514(b)(1)(A)(i) applies because its securities trading on margin was "substantially related" to the Trust's exempt purpose.

In Elliot Knitwear Profit Sharing Plan v. C.I.R., 614 F.2d 347 (3d Cir. 1980), the Third Circuit affirmed the tax court's determination that securities purchased on margin by the plaintiff profit sharing plan were debt-financed property and, as such, any income produced from the sales was subject to the UBIT. The plaintiff profit sharing plan presented the same two arguments as plaintiff asserts in this case as to why income earned was not subject to the UBIT. First, it argued that the exception to the definition of acquisition indebtedness in § 514(c)(4) applied because the purchase of the securities on margin was "inherent" in the plan's performance or exercise of its exempt purpose, that is, to accumulate income for its employee's retirement. Second, the plan argued that the income fell within the exception to the definition of debt-financed property set forth in § 514(b)(1)(A)(i) because the purchase of margin securities was "substantially related" to its exempt purpose.

As to the first argument, the Third Circuit adopted the tax court's finding that debt-financed investing was not inherent to the profit sharing plan's purpose of accumulating funds for its employees. The buying and selling of income-producing property, the Third Circuit noted, is a means to accomplish the purpose of the plan and is not the purpose of the plan itself. With respect to the second argument, the tax court found that § 514(b)(1)(A)(i) clearly included income-producing property which is held solely to produce income. The court, citing to the statute, noted further that the exception in §514(b)(1)(A)(i) does not apply to property that is "substantially related by virtue of 'the need of the organization for income or funds.'"

Two district courts have since followed Elliot Knitwear. In Alabama Cent. Credit Union v. United States, 646 F. Supp. 1199 (N.D. Alabama 1986), a nonprofit credit union sought a refund of income taxes paid on income earned from the purchase of securities on margin. The district court found that the acquisition of indebtedness in the purchase of securities was not inherent or substantially related to the credit union's tax-exempt purpose. In Ocean Cove Corp. Retirement Plan & Trust v. United States, 657 F. Supp. 776 (S.D. Florida 1987) , the district court, following Elliot Knitwear and Alabama Central, rejected these same two arguments by the plaintiff, a tax-exempt pension plan.

Here, the court rejects plaintiff's arguments based on the same rationale given by Elliot Knitwear and followed by Alabama Central and Ocean Cove. The Trust was created for the benefit of the University of New Haven. As such, the purchase and sale of securities on margin is not inherent or substantially related to its exempt purpose. Although margin

trading may produce higher returns than other investment vehicles, it is merely one way of accomplishing the Trust's charitable purpose and is clearly not the purpose of the Trust's existence.

Conclusion

For the foregoing reasons, plaintiff's motion for summary judgment [#12] is DENIED and defendant's motion for summary judgment [#7] is GRANTED.

Dated this 16th day of March 1998 at Bridgeport, Connecticut.

/s/_____
Warren W. Eginton,
Senior U.S. District Judge

APPENDIX C

UNITED STATES DISTRICT COURT
DISTRICT OF CONNECTICUT

[Filed March 22, 1998]

No. 3-96-1018 (WWE)

THE HENRY E. BARTELS AND NANCY HORTON BARTELS TRUST FOR THE BENEFIT OF THE UNIVERSITY OF NEW HAVEN, BY KENNETH G. BARTELS, JOHN P. LOEHMANN, PHILIP H. BARTELS, MARILOU McLAUGHLIN AND LAWRENCE J. DENARDIS, TRUSTEES, *Plaintiffs,*	)
v.	)
UNITED STATES OF AMERICA, *Defendant.*	)

PLAINTIFF'S MOTION FOR RECONSIDERATION

SUBJECT Ruling on Cross-Motions for Summary
DECISION: Judgment, Dated 3/16/98

The plaintiff in the above-entitled Action, THE HENRY E. AND NANCY HORTON BARTELS TRUST FOR THE BENEFIT OF THE UNIVERSITY OF NEW HAVEN, BY KENNETH G. BARTELS, JOHN B. LOEHMANN, PHILIP H. BARTELS, MARILOU . . .

5/20/98: The motion for reconsideration is GRANTED. Upon consideration, the Court's ruling dated 3/16/98 is hereby AFFIRMED.

/s/_____
Warren W. Eginton
Senior U.S. District Judge

APPENDIX D

THE INTERNAL REVENUE CODE OF 1986, AS AMENDED

• **Sec. 511.** **Imposition Of Tax On Unrelated Business Income Of Charitable, Etc., Organizations.**

(a) **Charitable, Etc., Organizations Taxable At Corporation Rates.**

(a)(1) **Imposition Of Tax.** There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(a)(2) **Organizations Subject To Tax.**

(a)(2)(A) **Organizations Described In Sections 401(a) And 501(c).** The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

(a)(2)(B) **State Colleges And Universities.** The tax imposed by paragraph (1) shall apply in the case of any

college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(b) **Tax On Charitable, Etc., Trusts.**

(b)(1) **Imposition Of Tax**. There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1(e). In making such computation for purposes of this section, the term "taxable income" as used in section 1 shall be read as "unrelated business taxable income" as defined in section 512.

(b)(2) **Charitable, Etc., Trusts Subject To Tax**. The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

(c) **Special Rule For Section 501(c)(2) Corporations.** If a corporation described in section 501(c)(2)--

(c)(1) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or which would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and

(c)(2) such corporation and such organization file a consolidated return for the taxable year,

such corporation shall be treated, for purposes of the tax imposed by subsection (a), as being organized and operated for the same purposes as such organization, in addition to the purposes described in section 501(c)(2).

• **512. Unrelated Business Taxable Income.**

(a) **Definition**. For purposes of this title--

(a)(1) **General Rule.** Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

. . . . .

(b) **Modifications**. The modifications referred to in subsection (a) are the following:

. . . . .

(b)(4) Notwithstanding paragraph (1), (2), (3) or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

. . . . .

• **Sec. 513. Unrelated Trade Or Business.**

(a) **General Rule**. The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)), except that such term does not include any trade or business--

(a)(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(a)(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or (a)(3) which is the selling of merchandise,

substantially all of which has been received by the organization as gifts or contributions.

. . . . .

• **Sec. 514. Unrelated Debt-financed Income.**

(a) **Unrelated Debt-financed Income And Deductions.** In computing under section 512 the unrelated business taxable income for any taxable year--

(a)(1) **Percentage Of Income Taken Into Account.** There shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness (as defined in subsection (c)(7)) for the taxable year with respect to the property is of (B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year.

(a)(2) **Percentage Of Deductions Taken Into Account.** There shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying (except as provided in the last sentence of this paragraph) the percentage derived under paragraph (1) to the sum determined under paragraph (3). The percentage derived under this paragraph shall not be applied with respect to the deduction of any capital loss resulting from the carryback or carryover of net capital losses under section 1212.

(a)(3) **Deductions Allowable**. The sum referred to in paragraph (2) is the sum of the deductions under this chapter which are directly connected with the debt-financed property or the income therefrom, except that if the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167, the allowance shall be computed only by use of the straight-line method.

(b) **Definition Of Debt-financed Property**.

(b)(1) **In General**. For purposes of this section, the term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition), except that such term does not include--

(b)(1)(A) (i) any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section (a)(2)(B), to the exercise or performance of any purpose or function designated in section (c)(3)), or (ii) any property to which clause (i) does not apply, to the extent that its use is so substantially related;

(b)(1)(B) except in the case of income excluded under section 512(b)(5), any property to the extent that the income from such property is taken into account in computing the gross income of any unrelated trade or business;

(b)(1)(C) any property to the extent that the income from such property is excluded by reason of the provisions of paragraph (7), (8), or (9) of section 512(b) in computing the gross income of any unrelated trade or business; or

(b)(1)(D) any property to the extent that it is used in any trade or business described in paragraph (1), (2), or (3) of section 513(a).

For purposes of subparagraph (A), substantially all the use of a property shall be considered to be substantially related to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 if such property is real property subject to a lease to a medical clinic entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

. . . . .

(c) **Acquisition Indebtedness**.

(c)(1) **General Rule**. For purposes of this section, the term "acquisition indebtedness" means, with respect to any debt-financed property, the unpaid amount of --

(c)(1)(A) the indebtedness incurred by the organization in acquiring or improving such property;

(c)(1)(B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(c)(1)(C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

. . . . .

(c)(4) **Indebtedness Incurred In Performing Exempt Purpose**. For purposes of this section, the term "acquisition indebtedness" does not include indebtedness the incurrence of which is inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption, such as the indebtedness incurred by a credit union described in section 501(c)(14) in accepting deposits from its members.

. . . . .

* * *

APPENDIX E

TREASURY REGULATIONS

Reg. §1.513-1 Definition Of Unrelated Trade Or Business.

(a) **In General**. As used in section 512 the term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of "unrelated trade or business" applicable to certain trusts, see section 513(b).) Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly

carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

(b) **Trade Or Business**. The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 - and which, in addition, is not substantially related to the performance of exempt functions-- presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried

on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

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